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C O N F I D E N T I A L SECTION 01 OF 03 HONG KONG 002027

SIPDIS

STATE FOR EAP/CM AND EEB/OMA; TREASURY FOR MCCORMICK,
DOHNER, AND WINSHIP

E.O. 12958: DECL: 11/03/2033
TAGS: ECON EFIN PREL HK
SUBJECT: HKG FEARS FINANCIAL CENTER AMBITIONS AT RISK FROM
MINIBONDS

REF: A. HONG KONG 1925
¶B. HONG KONG 1801
¶C. HONG KONG 1790
¶D. HONG KONG 1762
¶E. HONG KONG 1757
¶F. HONG KONG 1719

Classified By: Consul General Joseph Donovan, Reason 1.4 b/d

¶1. (C) Summary: The Hong Kong Legislative Council (Legco) is expected to decide November 12 whether to launch an investigation of bank misconduct in the sale of Lehman Bros.-issued minibonds. Local press has been filled for weeks with tragic stories of elderly investors who lost their life-savings after buying what they thought were safe assets. While regulators investigate allegations of misconduct, political parties have been quick to burnish their populist credentials, helping victims obtain media coverage and standing close by their side. The Hong Kong government believes its ambitions to become a global financial center are jeopardized by the possibility that Legco will use its Basic Law-defined "powers and privileges" to subpoena bank executives and confidential bank records. The government is pressuring banks involved in the marketing of these products to buy them back at some percentage of their face value now and agree to return any additional value to investors when the underlying collateral is sold. End Summary.

¶2. (C) Comment: The Hong Kong government's buyback proposal, that banks that marketed Lehman Bros. derivatives buy them back from investors at a relatively high percentage of their face value, suggests an administration vulnerable to populist appeals and calls into question the depth of the Tsang government's commitment to Hong Kong's free-market economic framework. There is no upside for the banks, other than the appealing prospect of avoiding an embarrassing political show trial in the Legco. Senior government officials agree that regulators are doing a credible job of processing complaints and recognize that their proposal flies in the face of orthodox Hong Kong economic policy, but counter that no one around the world is clinging to economic orthodoxy in the current financial environment. The obvious difference is that the Hong Kong government's buyback proposal isn't designed to address a systemic crisis, but a political one. Public attention is focused on bank improprieties, a politically more acceptable target, rather than on regulatory failings. The government believes its buyback plan will boost its popularity and prevent the Legco from savaging the banks. Officials here appear oblivious to the negative impact of populist arm-twisting tactics on Hong Kong's financial center ambitions. End Summary.

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The Minibond Saga
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¶3. (U) Over 43,000 Hong Kong retail investors purchased complex investment products issued by Lehman Bros. and sold through branches of local banks in Hong Kong, Macau and other economies in the region. Over 33,000 Hong Kong investors purchased US$1.6 billion worth of "minibonds" -- in fact not really bonds at all, but rather complex synthetic collateralized debt obligations (CDOs) linked to a portfolio of unspecified international credits. (Even sophisticated investors are unclear what the true nature of the underlying collateral really is.) The minibond prospectus clearly warned of the risky nature of the product, but its complexity calls into question whether regulators should have allowed these products to be sold to retail investors at all, said one former corporate financier. When Lehman Bros. went bust, these products failed to pay out scheduled dividends, leaving investors without their expected income stream and no clear understanding or access to the underlying assets of the instruments. While the underlying assets do have some value, the fall in equity prices and the illiquid nature of some of these assets make them difficult to value and even harder to sell.

¶4. (SBU) Hong Kong investors, encouraged by political parties eager to burnish their populist images, have taken to the streets and the media to demand that banks return their money. Oer 14,000 investors have filed complaints with the

Hong Kong Monetary Authority (HKMA), accusing the distributor banks of &mis-selling8 and failing to warn investors of the risks of these complex investments. The HKMA has re-assigned 100 people, about one-third of its banking supervision staff, and has hired contractors to investigate the validity of these complaints, but will not report their findings to the Financial Secretary until the end of the year. Misconduct is typically punished by substantial fines. HKMA's Executive Director for banking supervision said the government is seriously considering banning the sale of these types of complex products, but the move is opposed by banks, who see these products as revenue spinners. The Hong Kong Consumer Council (HKCC) has also jumped into the fray, announcing on October 30 that it has identified 50 complainants it may support in joint legal proceedings against the banks, if mediation efforts fail. Staff at the HKCC told econoffs they had identified the most egregious and media sympathetic cases available.

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Populist HKG Pressures Banks to Buy Back Minibonds
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¶5. (C) Undersecretary for Financial Services and the Treasury Julia Leung contacted the Consulate October 29 to discuss the Hong Kong government's controversial response to protesters eager to reclaim money lost after investing in Lehman Bros.-issued financial products. The Hong Kong government has publicly and privately pressured local banks to settle with minibond purchasers and has strongly pressed the banks to support a government proposed buyback scheme that would see distributor banks repurchase minibonds at some percentage of their face value. Leung explained that the government is trying to find a market solution that can pre-empt further political problems. She noted that the minibonds' underlying collateral still has some value, although she declined to repeat her earlier public estimate that 80 percent of the instruments will retain 60-70 percent of their value. She noted that many of these underlying assets had been rated AAA and retain much of their original value.

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HSBC an Obstacle to Returning Money to Investors

¶6. (C) Leung accused HSBC, the trustee for the underlying assets, of setting up roadblocks to the government's efforts to return funds to investors. The government has approached HSBC about the possibility of designating the Lehman Bros. bankruptcy as a "credit event." Doing so would force HSBC to unwind the US$1.6 billion fund and return money to investors, but would be difficult in the current financial climate and would almost certainly result in low returns. Many of the products are worth only a fraction of their purchase price, others are reportedly untradeable at this time.

¶7. (C) HSBC has declined to unwind the fund unless 20 percent of all minibond-holders vote to sell the collateral. (NOTE: With prices at current lows, investors have little incentive to press HSBC to sell now, particularly when their efforts to pressure the government to win back a larger percentage of their investment seem to be paying off. END NOTE) Leung said HSBC is not obligated to unwind the fund until all 32 minibond series have defaulted on interest payments, the last of which falls due in March 2009. It will then take 3-6 months to unwind the fund and return money to investors.

HKG to the Rescue

¶8. (C) To avoid making investors wait for their money, the government proposed the buyback scheme, said Leung. After considerable public and private arm-twisting by the government, the Hong Kong Association of Banks (HKAB) agreed to appoint auditor Ernst & Young to develop a formula to value the underlying assets in preparation for a buyback. The HKAB and the government agreed on the proposed formula on November 4, but the details have not yet been reported. Leung expected that the banks would offer investors a "haircut", say 40 cents on the dollar, even if the assessed

value is higher. If the assets appreciate beyond the buyback price, banks will be required to make up the difference to investors. If they depreciate, the banks will bear the loss.

¶9. (C) The government is trying its best to resolve the problem, said Leung. Many unsophisticated investors put their life-savings into these complex products without realizing the risk, she said. It is only right that the banks selling these complex products share the risk with the people. When asked whether the buyback program was compatible with Hong Kong's reputation as a liberal, free-market economy, Leung noted that many free-market economies are now taking measures that in years past would have been unthinkable.

Legco "Power and Privilege" Threatens Finance Ambitions

¶10. (C) The buyback scheme will benefit investors by giving them quicker access to their cash, but is also urgently needed to forestall plans by the Legislative Council (Legco) to exercise its "Powers and Privileges" under the Basic Law to subpoena bank executives and confidential bank records, said Leung. To date, these powers have only been used to subpoena government officials and documents, but apparently nothing in the law limits use against the private sector. Legco's power to compel witnesses to testify and subpoena confidential banking records for discussion in open session would severely damage Hong Kong's reputation as a financial center, she feared. On November 12, Legco will vote on whether to establish a Select Committee to investigate allegations of banks mis-selling financial products. With significant public interest in the issue, this could become a

media circus, warned Leung. If the Legco can subpoena confidential bank records and subject bank executives to grilling in front of the media, financial service companies will be reluctant to set up shop in Hong Kong, she claimed.

¶11. (C) Hong Kong Solicitor General Ian Wingfield confirmed to us that the Legco has the power to subpoena both public and private sector officials and documents. A Legco select committee could exercise this power, but it must be explicitly granted by the Legco President. Testimony in Legco is immunized, but could be publicly broadcast. Business proprietary information could be exempted from Legco subpoena, but there are precedents for sharing that type of information. Wingfield noted that Legco often threatens to convene a select committee to encourage cooperation, but in practice such committees are rarely convened.
DONOVAN